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IN THE

Supreme Court of the United States

October Term, 1966.

No. 782

MADISON FUND, INC.
(formerly The Pennroad Corporation),
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966.

No.

MADISON FUND, INC.
(FORMERLY THE PENNROAD CORPORATION),
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

Madison Fund, Inc. ("Petitioner") prays that writs of certiorari issue to review the judgments of the United States Court of Appeals for the Third Circuit entered in the above-entitled cases on July 26, 1966. Since the two cases involve identical questions, this petition covers both cases.

OPINIONS BELOW.

The two cases with respect to which writs of certiorari are here sought were consolidated for trial before the Tax Court of the United States and, upon appeal, were consolidated for hearing before the United States Court of Appeals for the Third Circuit. The opinion of the Tax Court (41a)[1] is reported in 43 T. C. 215. The opinion of the Court of Appeals affirming the Tax Court is printed in Appendix B, *infra*, page 2a, and is reported in 365 F. 2d 471. Chief Judge Staley dissented from the opinion of the Court of Appeals and his dissenting opinion is printed in Appendix B, *infra*, page 5a, and is reported in 365 F. 2d 471, 473. The opinion of the Court of Appeals denying Petitioner's petition for rehearing is printed in Appendix D, *infra*, page 9a, and is reported in 365 F. 2d 471, 473. Chief Judge Staley dissented from the Court of Appeals' denial of the petition for rehearing and his dissenting opinion is printed in Appendix D, *infra*, page 10a, and is reported unofficially in 18 AFTR 2d ¶ 66-5134.

JURISDICTION.

The judgments of the Court of Appeals, printed in Appendix C, *infra*, pages 7a and 8a, were entered on July 26, 1966. A petition for rehearing, timely filed by Petitioner, was denied August 24, 1966. The order denying the petition for rehearing is printed in Appendix E, *infra*, page 11a.

Petitioner invokes the jurisdiction of this Court under Section 1254(1) of the Judicial Code, 28 U. S. C. § 1254(1).

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1. This and similar references are to page numbers of Petitioner's Appendix filed with the Court of Appeals.

QUESTIONS PRESENTED.

1. Whether the Court of Appeals erred in failing to follow its prior decision,[2] which decision (a) turned, as do the present cases, solely on the issue of the proper tax treatment to be given proceeds received by Petitioner in 1947 in settlement of certain litigation and (b) was relied upon by Petitioner to its detriment.

2. Whether the Court of Appeals erred in requiring Petitioner to reduce the tax bases of certain investments which it held at the time proceeds were received in settlement of litigation when at the time of receipt Petitioner had already sustained actual losses of capital from the matters complained of in an amount greatly in excess of such proceeds.

STATUTE.

The statutory provision involved is section 1016(a)(1) of the Internal Revenue Code of 1954, 26 U. S. C. § 1016(a)-(1). It is printed in Appendix A, *infra*, page 1a.

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2. *The Pennroad Corporation v. Commissioner*, 228 F. 2d 329 (3d Cir., 1955) (10a).

STATEMENT OF THE CASE.

A. Nature of the Proceeding.

These cases involve Petitioner's corporate income tax liability for the calendar years 1956, 1958 and 1960. The dispute centers around the proper tax treatment to be given proceeds received by Petitioner from the Pennsylvania Railroad Company ("Pennsylvania") in settlement of all matters complained of in three stockholder derivative suits.

Upon receipt in 1947, Petitioner applied the settlement proceeds in reduction of losses of capital which it had already sustained from the matters complained of. Such losses were greatly in excess of the amount of the recovery. The Commissioner of Internal Revenue ("Respondent") determined that Petitioner should have applied a portion of the proceeds to reduce the tax bases of certain investments held by it in 1947, which investments were subsequently sold during the period 1952 to 1960. Respondent's adjustment had the dual effect of: (a) decreasing the capital loss carryover claimed by Petitioner in 1956 and (b) increasing the gain reported by Petitioner from the sale of certain investments in 1958 and 1960.

Pursuant to section 6212 of the Internal Revenue Code of 1954, 26 U. S. C. § 6212, Respondent issued statutory notices of deficiency. Pursuant to section 6213 of the Internal Revenue Code, 26 U. S. C. § 6213, Petitioner filed petitions for redetermination with the Tax Court. The Tax Court entered judgments for Respondent, and the Court of Appeals affirmed, thereby reversing its earlier decision involving Petitioner's 1947 income tax liability based on the same facts.

B. Facts.

The facts material to the consideration of the questions presented are as follows:[3]

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3. The facts, except as otherwise indicated, are from the Tax Court's findings (41a).

In 1947, pursuant to the terms of a settlement agreement, Pennsylvania paid Petitioner $15,000,000 in settlement of all matters complained of in three law suits which had been instituted against Pennsylvania and others by various of Petitioner's stockholders and holders of voting trust certificates.

The controversies which gave rise to the settlement had their roots in the late 1920's when Pennsylvania's officers and directors were seeking ways of expanding Pennsylvania's railroad empire without running afoul of the Interstate Commerce Commission or the Federal Anti-Trust laws. The result was the formation of Petitioner as a separate investment corporation under the name of The Pennroad Corporation.[4] While having the appearance of an independent entity, Petitioner was controlled by Pennsylvania through an interlocking Board of Directors, officers owing their allegiance to Pennsylvania, and a ten-year voting trust with three members of Pennsylvania's Board of Directors acting as voting trustees. Pennsylvania possessed full and complete power over the policies, investments and other acts of Petitioner.

Pennsylvania caused Petitioner to embark immediately upon a program of purchasing stock and securities in other railroad corporations to accomplish what Pennsylvania could not do in its own right and in its own name. Also, in the latter part of 1929 and as a part of this program, Petitioner was caused to issue at considerable expense additional voting trust certificates to provide additional funds with which to purchase stock. Finally, Pennsylvania caused Petitioner to form a subsidiary corporation which was designed to accept freight in less than carload lots and to ship it in carload lots over Pennsylvania's lines. As anticipated, Pennsylvania profited greatly from the existence of the subsidiary corporation through, among

4. Petitioner's name was subsequently changed to Madison Fund, Inc. on October 15, 1958.

other things, the added freight revenue received from the hauling of freight.

It was this set of facts which led to the institution by certain of Petitioner's stockholders and holders of voting trust certificates of lawsuits against Pennsylvania, the trustees of the voting trust, certain of Pennsylvania's directors and officers, and Petitioner. The first suit was instituted in 1932 in the Delaware Court of Chancery. There followed in 1939 and 1940 two additional suits in the District Court of the United States for the Eastern District of Pennsylvania. It was alleged in each of the three cases that Pennsylvania had formed and operated Petitioner solely for the benefit of Pennsylvania and by so doing had assumed a fiduciary relationship to Petitioner and to its stockholders, which relationship it breached. Specifically complained of in the suits were (a) the purchase and retention by Petitioner of stock in eight railroad companies, (b) the payment of the underwriter's fees in 1929, (c) the creation of the freight forwarding subsidiary and (d) the realization by Pennsylvania of net profits, at Petitioner's expense, from the freight forwarding venture.

In 1941 the District Court for the Eastern District of Pennsylvania rendered an opinion against Pennsylvania in the two cases which had been consolidated for trial before it.[5] In a supplemental opinion entered in 1943 it awarded Petitioner damages of $22,104,515.92.[6] Appeal was taken to the United States Court of Appeals for the Third Circuit which reversed the judgment against Pennsylvania on the grounds that suit was barred by the Pennsylvania statute of limitations.[7] The third suit, in the Delaware Court of Chancery and in which no statute

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5. *Overfield v. Pennroad Corporation* and *Weigle v. Pennroad Corporation* both reported in 42 F. Supp. 586.

6. *Overfield v. Pennroad Corporation* and *Weigle v. Pennroad Corporation* both reported in 48 F. Supp. 1008.

7. *Overfield v. Pennroad Corporation* and *Weigle v. Pennroad Corporation* both reported in 146 F. 2d 889 (1944).

of limitations was involved, was pending at the time and was ripe for trial.

In March 1945 Petitioner, which had by then achieved independence of management and had aligned itself with its complaining stockholders, executed a settlement agreement with Pennsylvania which provided for the payment by Pennsylvania to Petitioner of $15,000,000 in settlement of all matters complained of in the three suits. Payment was subject to certain conditions which were subsquently fulfilled and on February 19, 1947 Pennsylvania paid Petitioner the amount of the settlement. Payment of fees and expenses reduced the net recovery to $12,009,586.98.

At the time of settlement in 1947, Petitioner had actually sustained losses of capital of more than $22,000,000 from the matters complained of in the settled suits.[8] By the end of that year this figure had increased to over $31,000,000. The $12,000,000 of net settlement proceeds therefore did not begin to restore the losses of capital which Petitioner had already sustained. Petitioner continued to hold in 1947 a portion of the investments complained of in the suits, which investments were subsequently sold prior to the end of 1960 at a very substantial overall loss.[9]

For Federal income tax purposes, Petitioner viewed the matters complained of as a unit, applying the proceeds in 1947 first to restore losses of capital theretofore actually sustained. Since such losses greatly exceeded the net recovery, the proceeds restored only partially the capital actually lost. No portion of the net proceeds remained to be allocated to reduce the tax bases of the remaining investments then held by Petitioner. Since, pursuant to such

8. It has been stipulated by the parties hereto that the portion of such losses actually sustained without tax benefit exceeded the amount of the net recovery (16a-20a).

9. By the end of 1960, when all of the controverted investments had been sold, Petitioner realized a total loss of capital from the matters complained of in the Pennsylvania litigation in excess of $85,000,000.

treatment, the entire recovery represented a return of capital, Petitioner reported no portion of the proceeds as taxable income in 1947.

Respondent, in examining Petitioner's Federal income tax return for 1947, disagreed with Petitioner's treatment of the proceeds. He argued that Petitioner was required to treat each of the items complained of in the suits as a separate claim thereby requiring that the proceeds be segmented and allocated to certain of the items. By so doing, Respondent determined that Petitioner realized taxable income of $2,876,782.49 upon receipt of the proceeds in 1947.

Petitioner filed a petition for redetermination with the Tax Court. The Tax Court in *The Pennroad Corporation v. Commissioner* upheld Petitioner's treatment of the proceeds, stating:[10]

> "We think that respondent's insistence on treating each investment complained of as a separate claim to which a portion of the settlement must be allocated is unwarranted. The several transactions were actually nothing more than steps in the carrying out of Pennsylvania's plan to create and use petitioner as a vehicle for its own purposes otherwise barred by governmental restrictions. The basic nature of the claim lay in losses arising from a series of Pennsylvania's acts in furtherance of a continuing conspiracy."
>
> * * *
>
> "We hold, accordingly, that the entire sum received in settlement constituted a recovery of capital resulting in no income taxable to the petitioner."

The Court of Appeals for the Third Circuit affirmed stating:[11]

> "We agree. The amount which Pennroad received from the settlement was indeed far less than the capital

10. 21 T. C. 1087, 1098 (4a, 7a-8a).
11. 228 F. 2d 329, 332 (10a, 14a-15a).

loss which it sustained from Pennsylvania's illegal conduct. The capital which Pennroad lost was not restored by the settlement."

* * *

"We hold that, under the circumstances at bar, Pennroad was entitled to the restoration of its capital before the principle of allocation could become applicable."

C. Decisions of the Courts Below.

In determining Petitioner's tax liability for the calendar years 1956, 1958 and 1960, the Tax Court held, notwithstanding the prior decisions of the Tax Court and the Court of Appeals with respect to Petitioner's 1947 tax liability, that Petitioner's treatment of the settlement proceeds had been erroneous. The Tax Court determined that Petitioner should have allocated the proceeds among the complained-of investments to reduce the tax bases of such investments. This in turn affected the computation of gain or loss upon their subsequent sale.

The Court of Appeals affirmed the judgments of the Tax Court. Chief Judge Staley dissented from the Court of Appeals' opinion stating (Appendix B, *infra*, page 5a), in part:

"I respectfully dissent from the holding of the majority opinion. The disposition of this appeal revolves about the construction we give to the language of our earlier opinion in Commissioner v. Pennroad Corp., 228 F. 2d 329 (C. A. 3, 1955). The majority is content to state that 'a proper allocation would have been pointless for the purposes of that case' and 'neither our ruling, nor our language read in its context, in any way precluded an allocation of the lump sum settlement in the present case * * *.'

"With this I cannot agree. In Pennroad we held that 'under the circumstances at bar, Pennroad was en-

titled to the restoration of its capital before the principle of allocation could become applicable.' 228 F. 2d at 332. Insofar as I am concerned, this is the law of the case, and it should remain undisturbed unless there is a clear instance of previous error from which injustice may result. See White v. Higgens, 116 F. 2d 312, 317 (C. A. 1, 1940)."

D. Petitioner's Position.

It is Petitioner's position that the previous decision of the Court of Appeals in *The Pennroad Corporation v. Commissioner,* approving Petitioner's treatment of the settlement proceeds, established the law of these cases and that the Court of Appeals erred (a) in failing to follow its previous decision and (b) in allocating a portion of the proceeds in such a way as to reduce the tax bases of investments sold during 1952 to 1960.

REASONS FOR GRANTING WRITS.

I. The Decision of the Court of Appeals Below Has So Far Departed From the Accepted and Usual Course of Judicial Proceedings as to Call for an Exercise of This Court's Power of Supervision.

The treatment which Petitioner was required to give the settlement proceeds, upon receipt in 1947 from Pennsylvania, was initially in issue before the Court of Appeals in *The Pennroad Corporation v. Commissioner,*[12] a case involving Petitioner's tax liability for 1947. The Court in that case upheld Petitioner's unitary view of the Pennsylvania litigation and Petitioner's action in applying the proceeds to restore actual losses of capital already sustained by Petitioner. In so doing, the Court specifically rejected the Commissioner's contention that the nature of the litigation was such as to require that the individual items of claim be viewed as separate claims, with a corresponding allocation of the proceeds among such claims. The Court of Appeals stated:[13]

> "We hold that under the circumstances at bar, *Pennroad was entitled to the restoration of its capital before the principle of allocation could become applicable.*" [Emphasis added.]

At the time the proceeds were received Petitioner had already realized losses of capital greatly in excess of the amount of the recovery. Consequently no allocation of the proceeds among the items of claim was permitted by the Court. Instead the entire recovery was required by the Court to be applied to the actual losses of capital sustained prior to settlement. Petitioner accepted and relied upon

12. 228 F. 2d 329 (10a).
13. *Ibid* at 332 (15a).

the holding of the Court of Appeals as the final word on the subject.

Subsequently, in examining Petitioner's 1956, 1958 and 1960 Federal income tax returns, Respondent again questioned Petitioner's tax treatment of the settlement proceeds and again contended that they should have been allocated in 1947 among the investments complained of in the settled litigation. Petitioner took the position that the decision of the Court of Appeals with respect to its 1947 income tax had decided this question by requiring it to apply the entire settlement against losses of capital actually sustained prior to receipt of the proceeds. The Tax Court disagreed with Petitioner and held that the previous decision of the Court of Appeals did not preclude a determination that the proceeds should have been allocated in 1947 among the investments complained of for purposes of computing Petitioner's 1956, 1958 and 1960 tax liability.[14] The Court of Appeals, over a dissent, affirmed, stating:[15]

> "Finding nothing speculative, illogical or unfair in this analysis or in its results, we shall sustain the challenged allocation."

Petitioner submits that this statement is inaccurate, as the most recent holding of the Court of Appeals is manifestly unfair.

The complete reversal by the Court of Appeals has caught Petitioner in the jaws of a judicial vise.[16] Petitioner was, during the years in question, and continues to

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14. 43 T. C. 215 (41a).

15. Appendix B, *infra*, page 5a.

16. The majority of the Court of Appeals carefully avoids the word "overrule" in its opinion when referring to its previous decision. However Chief Judge Staley had no such inhibitions for in his dissenting opinion on petition for rehearing he wrote: ". . . it is clear to me that the court has overruled our previous opinion in this case, Commissioner v. Pennroad Corp., . . .". Appendix D *infra*, page 10a.

be, a regulated investment company under Subchapter M, Chapter 1 of the Internal Revenue Code of 1954, 26 U. S. C. § 851 *et seq.* As such any income or gain realized by it is not subject to Federal income tax to the extent that the company passes such income or gain on to its stockholders within a specified length of time. If the Court of Appeals had originally held that the proceeds were required to be allocated among the items of claim, obviously such an allocation would have been made together with a distribution relieving Petitioner of tax. However, since the Court of Appeals in the original case prohibited an allocation among the items of claim, there was during each of the years now in question no gain to be passed on. The Court in reversing itself now holds, after the period has expired for passing gain on to its stockholders without incurring a corporate tax, that the proceeds should have been allocated among the investments upon receipt in 1947.

This reversal of position by the Court has created a substantial tax liability which, but for the Court's original decision, would not otherwise exist. Petitioner will, under the Court's most recent decision, be required to recognize over $6,000,000 in additional taxable gain for the years in question. Petitioner is penalized for having relied upon the original decision of the Court of Appeals. Moreover Respondent is the beneficiary of a very substantial tax windfall. Petitioner believes that this constitutes such a departure from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

In the original case and in the present cases the parties and the basic facts (i.e., Petitioner's 1947 recovery from Pennsylvania) are identical. Moreover, the underlying issue for decision is the same; namely the tax accounting required of Petitioner in respect of the settlement proceeds when received in 1947. The first case involved the consequence of such accounting as regards Petitioner's 1947 tax liability whereas the present cases involve the conse-

quence in terms of its liability for subsequent years. However, the treatment of the proceeds upon receipt in 1947 is the sole bone of contention in all the cases. The determination of this question in the first case necessarily established the law of the cases at bar. See *Hugh B. Monjar*, 13 TC 587, 615 (1949); *Lentin v. Commissioner*, 226 F. 2d 695 (7th Cir. 1955), cert. den. 350 U. S. 934 (1956).[17]

There has been no substantive change in the applicable tax laws subsequent to the first decision. Consequently there is no room here for a contention that adherence by the Court of Appeals to its opinion in the earlier case would have been inequitable as between Petitioner and other taxpayers. Compare *White v. Higgins*, 116 F. 2d 312 (1st Cir. 1940) with *Commissioner v. Sunnen*, 333 U. S. 591 (1947).

Moreover, adherence by the Court of Appeals to its first decision would unquestionably have been equitable as between Petitioner and Respondent. It is patently equitable to ask that findings of fact previously made be followed in a subsequent case between the parties where such findings were essential to the holding in previous litigation. *The Evergreens v. Nunan*, 141 F. 2d 927, 929 (2d Cir. 1944), *cert. den.* 323 U. S. 720.[18] The factual determination in the previous case, that Pennsylvania's course of conduct was unitary (thereby precluding an allocation of the proceeds), was pivotal to the first judgment of the Court of Appeals.

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17. In the *Monjar* case, the Court had to decide whether certain payments were income or loans. It held that the issue had already been presented and decided, in a prior judgment convicting the taxpayer under the Securities Act for fraudulent "sale" of securities, on the same facts. In the *Lentin* case, the Court had to decide whether an amount paid in satisfaction of an OPA judgment was deductible as a business expense. The Court held that the answer depended, in turn, on whether the OPA violation had been willful. It then held that this issue had been presented and decided in the OPA proceedings.

18. *The Evergreens* was specifically approved on this point by this Court in *Commissioner v. Sunnen*, 333 U. S. 591, 601 (1947).

In failing to adhere to its previous determination, the Court has chosen to ignore the doctrine established by this Court in *Commissioner v. Sunnen* wherein it was stated at 601:

> "Of course, where a question of fact essential to the judgment is actually litigated and determined in the first tax proceeding, the parties are bound by that determination in a subsequent proceeding even though the cause of action is different. See *The Evergreens v. Nunan*, 141 Fed. (2d) 927. And if the very same facts and no others are involved in the second case, a case relating to a different tax year, the prior judgment will be conclusive as to the same legal issues which appear, assuming no intervening doctrinal change."

Especially relevant to the question of equity as between Petitioner and Respondent is the fact of Petitioner's heavy and justifiable reliance on the rule of law laid down in the previous litigation. In reliance on the Court of Appeals' first judgment, Petitioner followed a certain policy with respect to its distributions to stockholders. Petitioner's justifiable reliance ought now to be protected by adherence to the prior decision.[19]

In sum, it is submitted that the manner in which the Court below disposed of its prior decision was improper in judicial proceedings. Certiorari should be granted because the judgment below is inconsistent with the correct administration of the federal courts. If ever there existed a tax case requiring the exercise of this Court's power of supervision, this is that case, because the Court below has done in this case precisely what it said in the earlier case could not be done, namely "to treat loss as gain".[20]

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19. IB Moore, *Federal Practice*, ¶ 0.404[3] *passim* (second ed. 1965).

20. 228 F. 2d 329, 332 (15a) "To hold to the contrary in the instant case is to treat loss as gain."

II. The Question Presented Is of Considerable Importance in the Administration of the Federal Tax Laws.

The question presented in the cases is of considerable importance in the administration of the Federal tax laws and should, with the number of damage recoveries steadily increasing, be decided at this time. Each time a sum is received by a taxpayer as compensation for damages sustained, he must determine how the proceeds are to be treated for Federal income tax purposes.

This Court has in several decisions provided clear guidelines for determining the circumstances under which the proceeds must be treated as taxable income and those circumstances under which the proceeds are to be treated as a nontaxable return of capital. Unfortunately, this Court has never decided the related and important question of what constitutes a "proper adjustment", within the meaning of section 1016(a) of the Internal Revenue Code of 1954, 26 U. S. C. § 1016(a), for that portion of a recovery which is found to represent a nontaxable return of capital. This question must be answered by every taxpayer who receives a return of capital recovery encompassing more than one item of claim.

The cases at bar are particularly appropriate for a decision of the issue in that they involve settlement proceeds received in settlement of three lawsuits embracing ten different items of claim. A decision in these cases would, therefore, necessarily establish a clear rule of law touching upon a broad array of settlement recoveries.

CONCLUSION.

For the foregoing reasons, this petition for writs of certiorari should be granted.

Respectfully submitted,

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APPENDIX A.

Internal Revenue Code of 1954.

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

* * *

APPENDIX B.

Opinion of the Court Below.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 15589 and 15590

MADISON FUND, INC.
(FORMERLY THE PENNROAD CORPORATION)

MADISON FUND, INC.
Petitioner in No. 15589

v.

COMMISSIONER OF INTERNAL REVENUE

MADISON FUND, INC.
(FORMERLY THE PENNROAD CORPORATION)

MADISON FUND, INC.
Petitioner in No. 15590

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS TO REVIEW DECISIONS OF THE TAX COURT OF THE UNITED STATES

Argued April 18, 1966

Reargued June 10, 1966

Before: STALEY, *Chief Judge;* and MCLAUGHLIN, KALODNER, HASTIE, GANEY, SMITH and FREEDMAN, *Circuit Judges.*

OPINION OF THE COURT

(Filed July 26, 1966)

By HASTIE, *Circuit Judge.*

The petitioning taxpayer, Madison Fund, Inc.,—formerly The Pennroad Corporation—is contesting Tax Court decisions, 43 T.C. 215, determining deficiencies in its income tax for the taxable years 1956, 1958 and 1960. The matter in dispute is the computation of gain or loss upon the taxpayer's sales of securities from time to time between 1952 and 1960.[1] More specifically, the question is whether the basis of each security thus sold should be reduced and, if so, how much, by reason of the taxpayer's receipt from the Pennsylvania Railroad in 1947 of the net amount of approximately $12 million in settlement of certain stockholders' derivative suits.

The claims thus settled in 1947 were based upon the conduct of the Pennsylvania Railroad in causing the taxpayer, which Pennsylvania controlled, to make a number of specified disastrous investments of its assets which were calculated to serve the interests of Pennsylvania at the taxpayer's expense. Among the detrimental transactions alleged were the purchases at inflated prices of the various securities, subsequently sold between 1952 and 1960, which are involved in this case. The present dispute arises because, in computing gain or loss on each of these sales, the Tax Court determined the taxpayer's adjusted basis for the securities by subtracting from their cost that part of the 1947 settlement which the court found to represent a partial restoration of the capital invested therein.

On its face this appears to be a normal and proper way of determining gain or loss on the sale of property. For ordinarily a recoupment or recovery of part of the cost of property is an event that most obviously calls for

1. Losses on sales which occurred before 1956 are in issue because of claimed capital loss carry-over to 1956.

a reduction of original cost basis in determining what gain or loss is subsequently realized on sale. *Cf. Henri Chouteau,* 1931, 22 B.T.A. 850; *Estate of Collins,* 1942, 46 B.T.A. 765, upheld in *Dobson v. Commissioner,* 1943, 320 U.S. 489. Indeed, such is the plain requirement of the Internal Revenue Code. 26 U.S.C. §§ 1001, 1011, 1012, 1016.

In this case neither party doubts that in legal contemplation the 1947 settlement constituted a partial restoration of capital which had been dissipated as a result of Pennsylvania's wrongdoing. Indeed, we so ruled in 1955 when we decided that the proceeds of the 1947 settlement were not income. *Commissioner v. Pennroad Corp.,* 228 F.2d 329. However, the taxpayer argues that the circumstances of this case and the language of our 1955 *Pennroad* decision preclude any allocation of the $12 million recovery now to accomplish a downward adjustment of cost basis in the computation of gain or loss on sales of securities covered by the 1947 settlement.

When we considered certain tax consequences of the 1947 settlement in the *Pennroad* case, the question presented and decided was whether part of that settlement had constituted the realization of taxable income in that year. The Commissioner had allocated the total amount of the settlement among only a few of the capital expenditures involved in the settled suits, with the result that the settlement appeared to yield some taxable income. The Tax Court and this court concluded that this was error. We pointed out that dissipation of the taxpayer's capital as a result of wrongs redressed by the 1947 settlement far exceeded the $12 million recovery. Therefore, the effect of the Commissioner's allocation was as we said, "to treat [a mere reduction of] loss as gain". Technically, a properly inclusive allocation would not have been error, but it would not have provided any support for the Commissioner's position because it would not have shown any gain. In brief, a proper allocation would have been point-

less for the purposes of that case. And so we ruled "that, under the circumstances [then] at bar, Pennroad was entitled to the restoration of its capital before the principal of allocation could become applicable". 228 F.2d 332. Therefore, neither our ruling, nor our language read in its context, in any way precluded an allocation of the lump sum settlement in the present case for the quite proper and useful purpose of realistically taking this partial restoration of the cost of property into account in determining gain or loss on future sales of that property.

It remains to consider the taxpayer's contention that in the circumstances of this case a fair and rational allocation of the $12 million settlement among various assets has not been made and cannot be made. The opinion of the Tax Court sets out at length both the mechanics and the justification of the allocation made of the lump sum capital recovery among various assets. Finding nothing speculative, illogical or unfair in this analysis or in its results, we shall sustain the challenged allocation.

The decisions will be affirmed.

STALEY, *Chief Judge,* dissenting.

I respectfully dissent from the holding of the majority opinion. The disposition of this appeal revolves about the construction we give to the language of our earlier opinion in Commissioner v. Pennroad Corp., 228 F.2d 329 (C.A.3, 1955). The majority is content to state that "a proper allocation would have been pointless for the purposes of that case" and "neither our ruling, nor our language read in its context, in any way precluded an allocation of the lump sum settlement in the present case * * *."

With this I cannot agree. In Pennroad we held that "under the circumstances at bar, Pennroad was entitled to the restoration of its capital before the principle of allocation could become applicable." 228 F.2d at 332. In-

sofar as I am concerned, this is the law of the case, and it should remain undisturbed unless there is a clear instance of previous error from which injustice may result. See White v. Higgens, 116 F.2d 312, 317 (C.A.1, 1940).

There has been no showing that the entire settlement was used for the restoration of capital, as our previous opinion requires, before there may be an allocation. Nor has there been any showing that our opinion in Pennroad is clearly erroneous or that injustice may result. The majority merely states that it finds nothing speculative, illogical or unfair in the allocation.

I would remand these cases to the Tax Court for a determination not inconsistent with our earlier opinion as we now construe it.

APPENDIX C.

Judgments of the Court Below.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 15589

MADISON FUND, INC.,
(FORMERLY THE PENNROAD CORPORATION)

MADISON FUND, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

(T. C. Docket No. 93718)

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: STALEY, *Chief Judge,* and MCLAUGHLIN, KALODNER, HASTIE, GANEY, SMITH and FREEDMAN, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

ATTEST:

IDA O. CRESKOFF,
Clerk.

July 26, 1966

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 15590

MADISON FUND, INC.,
(FORMERLY THE PENNROAD CORPORATION)
MADISON FUND, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

(T. C. Docket No. 4194-62)

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: STALEY, *Chief Judge*, and MCLAUGHLIN, KALODNER, HASTIE, GANEY, SMITH and FREEDMAN, *Circuit Judges*.

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

ATTEST:

IDA O. CRESKOFF,
Clerk.

July 26, 1966

APPENDIX D.

Opinion of Court Below on Petition for Rehearing.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 15589 and 15590

MADISON FUND, INC.,
(FORMERLY THE PENNROAD CORPORATION)
MADISON FUND, INC.,
Petitioner in No. 15589,

v.

COMMISSIONER OF INTERNAL REVENUE

MADISON FUND, INC.,
(FORMERLY THE PENNROAD CORPORATION)
MADISON FUND, INC.,
Petitioner in No. 15590,

v.

COMMISSIONER OF INTERNAL REVENUE

Present: STALEY, *Chief Judge,* and MCLAUGHLIN, KALODNER, HASTIE, GANEY, SMITH, FREEDMAN and SEITZ, *Circuit Judges.*

SUR PETITION FOR REHEARING
(Filed August 24, 1966)

PER CURIAM:

The taxpayer's petition for rehearing has not persuaded a majority of the court that our decision affirming the Tax Court should be reconsidered.

Accordingly, the petition is denied.

By THE COURT:

WILLIAM H. HASTIE,
Circuit Judge.

STALEY, *Chief Judge*, dissenting.

I dissent from the denial of the petition for rehearing as it is clear to me that the court has overruled our previous opinion in this case, Commissioner v. Pennroad Corp., 228 F.2d 329 (C.A.3, 1955), which is, as far as I am concerned, the law of the case.

APPENDIX E.

Order Sur Petition for Rehearing.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 15589 and 15590

MADISON FUND, INC.,
(FORMERLY THE PENNROAD CORPORATION)

MADISON FUND, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

SUR PETITION FOR REHEARING

Present: STALEY, *Chief Judge*, and MCLAUGHLIN, KALODNER, HASTIE, GANEY, SMITH, FREEDMAN and SEITZ, *Circuit Judges.*

The petition for rehearing filed by Petitioner, Madison Fund, Inc. in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

ATTEST:

IDA O. CRESKOFF,
Clerk.

Dated: August 24, 1966

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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 782

MADISON FUND, INC. (formerly The Pennroad Corporation), PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This case involves the meaning of a prior decision rendered by the Third Circuit. The Third Circuit, sitting *en banc*, upheld the Commissioner's interpretation. In view of the limited question involved, no further review is warranted.

In 1947 petitioner received approximately $12,000,000 in settlement of three shareholders' derivative suits. In those suits the plaintiffs asserted that the Pennsylvania Railroad had controlled the petitioner and compelled it to invest in the stock of eight railroad companies at exhorbitant prices, and to conduct freight forwarding transactions through a subsidiary

for the benefit of Pennsylvania and to loss of its own shareholders.

The Commissioner asserted an income tax on a portion of the $12,000,000 recovered by petitioner in 1947 on two grounds. First, he alleged that part of the recovery represented a claim for lost profits from the freight forwarding venture which would have been ordinary income. Second, he allocated the balance of the recovery to four of the investments involved in the suits, reducing the basis of each asset and producing income in the case of one investment, the adjusted basis of which was less than the amount allocated to it.

The Tax Court rejected the Commissioner's attempt to tax any of the $12,000,000 in the year of receipt on the grounds that none of the recovery represented lost profits and that the Commissioner's method of allocation was arbitrary. *Pennroad* v. *Commissioner,* 21 T.C. 1087. In affirming, the Third Circuit stated (228 F. 2d 329, 332):

> We hold that, under the circumstances at bar, Pennroad was entitled to the restoration of its capital before the principle of allocation could become applicable. * * *

This present litigation arises from a dispute over the meaning of that sentence.

After 1947 petitioner sold the remaining investments involved in the three derivative suits. In computing its gain or loss on the sales petitioner made no adjustment to the basis of each asset to account for the partial restoration of capital represented by the $12,000,000 recovery.

The Commissioner rejected this procedure and asserted that some adjustment to basis was necessary. The Code clearly requires an adjustment of basis for a return of capital. 1954 Code §§ 1001, 1002, 1011, 1016. In a case like the present one where a lump sum is received as a partial return of the capital which a taxpayer has invested in an aggregate of assets, the amount recovered must be allocated among the assets on a pro rata basis in order to determine gain or loss in the year of sale. *Bancitaly Corp.* v. *Commissioner,* 34 B.T.A. 494; *Warren* v. *Commissioner,* 193 F. 2d 996 (C.A. 1); *Blum* v. *Commissioner,* 5 T.C. 702; *Santa Maria Gas Co.* v. *Commissioner,* 10 B.T.A. 1412.

Petitioner did not contest these general principles but asserted that in this case no allocation was necessary because the Third Circuit had held, as quoted above, that "Pennroad was entitled to the restoration of its capital before the principle of allocation could become applicable." Since it was admitted that Pennroad had realized a greater loss than it had recovered, petitioner contended that no allocation was necessary.

The Commissioner, on the other hand, took the position that petitioner was misconstruing the sentence it relied on. The Third Circuit in its original opinion did not decide whether the amount recovered should be allocated among the various investments for purposes of determining gain or loss in the year of sale. The Commissioner asserted that the prior opinion, and the sentence in question, merely addressed itself to the issue then before the court—whether the

$12,000,000 recovery could be allocated in the year of receipt to produce income in that year—and not to the issue of the basis of the assets at the time of a later sale. The dispute between the parties thus boiled down to what the Third Circuit meant in its prior decision.

In the instant case the Tax Court (43 T.C. 215) agreed with the Commissioner's interpretation of the Third Circuit's opinion because, it reasoned, accepting petitioner's contention "would do violence to the statutory scheme of reporting gains and losses on an annual basis." 43 T.C. at 231. Accordingly, it allocated the $12,000,000 among the assets on the basis of their relative fair market values—a method not challenged by the petitioner. On appeal the Third Circuit, sitting *en banc,* including one judge who sat on the original panel, rejected the petitioner's interpretation of its original opinion and agreed with the Commissioner. 365 F. 2d 471.

The Third Circuit's decision is clearly correct. It is in harmony with the general principle that where a lump sum has been received as a partial return of the capital which a taxpayer has invested in an aggregate of assets, the recovery must be allocated pro rata among the assets as a reduction of the taxpayer's basis in the assets. Furthermore, since the issue in this litigation is what the Third Circuit meant in its prior opinion, the Third Circuit sitting *en banc* is the court best qualified to answer that question.

Petitioner raises for the first time in its petition the argument that its reliance on its own misconstruction of the original opinion will produce an income tax liability it could have avoided. Assuming that is the case, there is certainly no principle of law that detrimental reliance on its own erroneous construction of a judicial opinion entitles a litigant to have that erroneous construction accepted.

The decision below is correct and involves no conflict of decisions or important question. The petition for a writ of certiorari should, therefore, be denied.

Respectfully submitted.

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DECEMBER 1966.

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